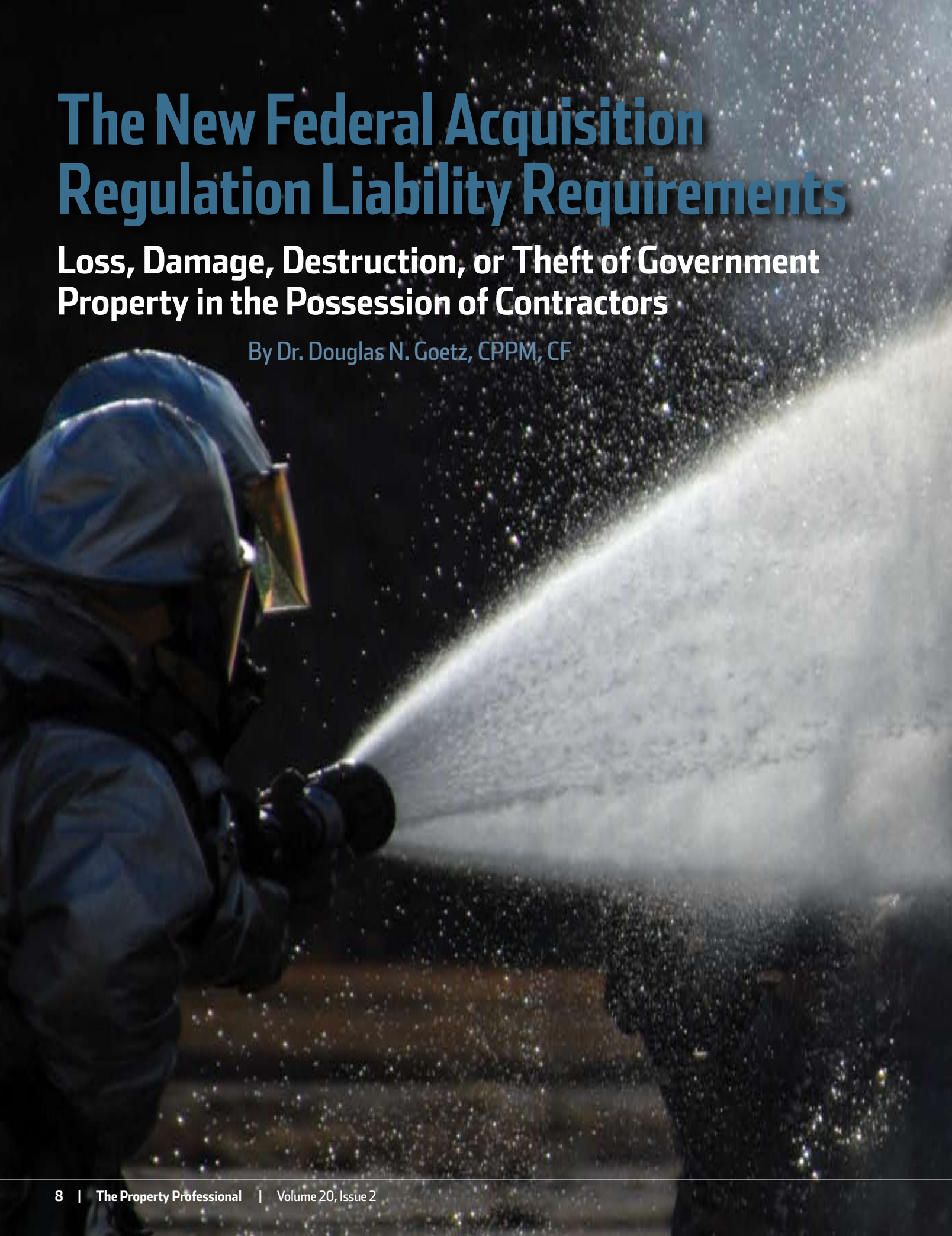
The New Federal Acquisition Regulation Liability Requirements

Loss, Damage, Destruction, or Theft of Government Property in the Possession of Contractors

By Dr. Douglas N. Goetz, CPPM, CF



The views expressed herein are those of the author and do not necessarily reflect the views of the Defense Acquisition University or the Department of Defense.

I have lectured extensively about the issue of liability. It is one of my FAVORITE areas—and one that is much misunderstood, and even more disturbing, much misapplied—by even the most experienced Government Property Administrator and contractor employee. Therefore, with the rewrite of FAR Part 45 it seems a propitious time to resurface the topic and expand the depth and breadth of discussion. I will cover the two most frequently used forms of liability —the "full" risk of loss provisions and the "limited" risk of loss provisions. And yes, in this article, the Drunken Forklift Operator WILL ride again!

As this is a revisitation of liability, I have learned a few things since last writing about this topic:

1. People generally respond EMOTIONALLY to this topic! We often hear the following, "You lost, damaged or destroyed my property! How could you? Well, you'd better PAY UP!" Maybe—maybe not! Emotion, whether on the part of the Government Property Administrator, Commanding Officer, Contracting Officer or the contractor's personnel—either managerial or property clerk, has no place in the determination of liability under a contract. Disregard all of your emotional baggage and think purely analytically.

2. People do not READ THE CONTRACT! I cannot tell you the number of times that I have had a telephone call from a property professional in the field. "We just had an incident where the contractor destroyed some government property. Are they liable?" How should I know? First off—READ THE CONTRACT! Which Government Property Clause is in the contract? Until you have determined this first step, all other determinations are for naught.

3. Bosses generally respond emotionally. Read item 1 above. Regardless of how much analysis the Government Property Administrator has engaged in—his or her boss responds in an emotional fashion. Emotion has no place in this determination.

Due to the complexity of the topic, and space limitations, I am splitting this article into TWO parts. This is Part 1, and Part 2 will appear in the next issue of *The Property Professional.*

So, with that said let's have at it—a discussion of the TECHNICAL issues of liability for loss, damage or destruction of government property in the possession of contractors.

For the traditional liability provisions (Full and Limited), I plan to divide this discussion into five parts. These parts consist of:

- The Government's Policy
- Clausal Requirements
- Why?

- Contractor Property Administrator Responsibilities, and
- Government Property Administrator Responsibilities.

I plan to walk through these parts in an attempt to establish the various relationships that exist between all of the players as well as provide a firm regulatory and legalistic perspective so all of us may understand the workings of the liability process and product.

The Goverment's Policy

The federal government's official policy towards liability for loss, damage or destruction is contained within the Federal Acquisition Regulation (FAR) at 45.104, entitled "Responsibility and liability for government property." It states,

"(a). Generally, contractors are not held liable for loss, damage, destruction, or theft of Government property under the following types of contracts—
(1) Cost reimbursement contracts;
(2) Time and material contracts;
(3) Labor hour contracts; and
(4) Negotiated fixed price contracts for which the price is not based upon an exception at FAR 15.403-1."

The first part of this sentence seems simple enough; generally the contractor is not held liable for the loss, damage, destruction, or theft of government property. O.k., the contractor is not liable. But the government added that simple word—GENERALLY. What does this mean? Simply put, there are situations where the government MAY REQUIRE that the contractor be held liable or there may be actions taken or not taken that cause a contractor to be liable. Can the government change its mind and say that the contractor IS responsible and liable for government property? Yes! We have to consider the second part of the sentence where a variety of contract types are listed. These include:

(1) Cost reimbursement contracts;
(2) Time and material contracts;
(3) Labor hour contracts; and
(4) Negotiated fixed price contracts for which the price is not based upon an exception at FAR 15.403-1.

Under these SPECIFIC types of contracts it is the GENERAL policy that contractors are NOT liable for the loss, damage, destruction, or theft of government property. In this case the "Limited Risk of Loss" provision of the government property clause is applicable, specifically FAR 52.245-1(h).

But there are OTHER types of contracts and even situations where the contractor IS held Liable. There is one pricing arrangement that is NOT included within the four listed above—that is a FIRM FIXED PRICE Contract—where an exception at FAR 15.403 APPLIES. If a FIXED PRICE contract is awarded the contracting officer may require the contractor to be liable for the loss, damage, destruction, or theft of government property. The contracting officer would do this through the inclusion of the Alternate I to FAR 52.245-1—what is referred to as at "Full" risk of loss provision.

Lastly, in this policy section there is one other point of discussion regarding loss, damage, destruction or theft of government property. FAR 45.104 additionally states,

"The contracting officer may revoke the Government's assumption of risk when the property administrator determines that the contractor's property management practices are inadequate and/or present an undue risk to the Government."

I am not going to discuss the "WHYS" at this point. I will leave that for later. From this perspective, we should be able to see, or at least have some idea, that there appears to be two forms of liability emerging. Our initial statement that under certain types of contracts the contractor is generally not held liable and that under

another type of contract the contractor is liable for government property. "But wait a minute," you say, "This section, FAR 45.104, is policy, and I'm a contractor, and policy is not binding upon me unless implemented through some type of contractual obligation." Let us see where this implementation occurs.

Clausal Requirements

The first place for us to look for a contractual obligation would be the government property clauses. It would be logical to also look at the simplest form of contract—the Fixed Price contract. It is important to note that this analysis will deal first with the FULL risk of loss provision and then with the LIMITED risk of loss.

Firm Fixed Price Contract

The Fixed Price Government Property Clause is found at FAR 52.245-1. The specific section of this clause that deals with liability is found at Alternate I, paragraph (h). It states,

"The Contractor assumes the risk of, and shall be responsible for, any loss, damage, destruction, or theft of Government property upon its delivery to the Contractor as Government furnished property. However, the Contractor is not responsible for reasonable wear and tear to Government property or for Government property properly consumed in performing this contract."

It's nice to be able to cite the FAR but we must go one step further and interpret its meaning. Very simply, under this clause the contractor is responsible for ALL loss, damage and destruction of government property REGARDLESS OF HOW IT HAPPENS! Whether it was a loss through theft, damaged through fire or flood, or destroyed through a California earthquake makes no difference whatsoever. The contractor is still liable!

There are two exceptions. One is for reasonable wear and tear, the other for proper consumption. For instance, if a contractor is provided, as Government Furnished Property, some Special Tooling (ST) under this fixed price contract. The government would be unreasonable if they were to expect to receive that tooling back in the exact same condition as when it was provided. The government realizes and expects there to be usage of the ST and therefore expects there to be "reasonable wear and tear." Likewise, if government property of the material classification is provided under this contract we would expect there to be reasonable consumption. With this responsibility

for "ALL" loss, damage, destruction or theft, one would think a contractor reasonably prudent to carry insurance. Since this contract was or is based upon adequate price competition, there is no problem with this. The government realizes that, in this instance its burden of the risk, the insurance risk for the protection of the government property, is not inordinate and therefore there is no prohibition against carrying insurance.

One problem that arises with this provision is the operationalization of the word "ANY." For example, let's assume that a contractor working under a fixed price contract containing this clause, FAR 52.245-1 with the Alternate I, paragraph (h), loses an item of ST. The ST's original acquisition cost was $200. Unfortunately, it was also ten years old and had seen better days. The contractor reports the loss to the Government Property Administrator (PA). The Government PA reviews the contract, sees this clause and makes the determination that the contractor should be held liable and forwards the recommendation to the Administrative Contracting Officer (ACO) for review and determination. (Note —the PA DOES NOT have the AUTHORITY to HOLD the contractor liable. That is a CO Function!) The ACO gets the letter and sends for the PA. "I am going to hold the contractor liable for this lost Special Tooling," says the ACO. "How much should I assess as the value of the lost Special Tooling?" The PA says, "The acquisition cost -- that is the cost at which all of the government property records are maintained."[1]

Are you sure about the AMOUNT for assessment of liability?

Consider for a minute—What value would you assess for the lost ST? Ah, I hear the shouts already.

"The ST was ten years old; we want to offer depreciated cost."

"Wait a minute, I want appreciated value—that ST would cost more now to fabricate or acquire than it did ten years ago."

"Hey, it was nothing more than scrap. I'll give you SCRAP value!"

"But, I still need it, so I want it replaced or provide me REPLACEMENT value!"

Think about it. In the last few sentences we've had multiple different values applied to that one item of ST. Acquisition Cost, Depreciated Cost, Appreciated Cost, Scrap Value! Which one does the ACO apply? So far, we have no guidance as to HOW MUCH a contractor should be held liable for. In fact, up until 1985 the ONLY value PAs were to apply was the original acquisition cost. But in 1985 things changed. It just so happens that a court decision has provided us some guidance. It seems that there was a contractor in California who was awarded a fixed price contract for processing and developing some motion picture film of Army Troop Movements over in Korea, provided as Government Furnished Property. This contract contained the old FAR Fixed Price Government Property Clause 52.245 2 with the regular paragraph (g) Risk of Loss provision—essentially the FULL risk of loss provision. The contractor lost the film. What value should the government recoup for this lost film?

Think about your own life and experiences for a moment. We bring our film to be developed, as an example, to the local Wal-Mart.[2] We receive a receipt for the film that states the company's liability is limited, and if they lose the film they will provide us a new free roll of film. That's all, nothing else. Although our Aunt Tillie's last pictures, may she rest in peace, were on that roll of film, and she meant a lot to us, all that we are going to receive from Wal-Mart is a free roll of film.

Well, the contractor made the same claim. They were willing to provide the government a new free roll of film. The ACO was not too pleased with this decision and, needless to say, there arose a dispute which ended up in the hands of the Armed Services Board of Contract Appeals. The Armed Services Board of Contract Appeals (ASBCA), one of the avenues for appeal that contractors may take when they disagree with the government's decision(s), reviewed the FAR and the Department of Defense Federal Acquisition Regulation Supplement (DFARS) and could find no direction as to what value should be placed on the lost film. Furthermore, they could find no federal contract decision addressing this point. Therefore, they went to state law and they decided to seek professional help. They asked Judge Wapner, Judge Judy, Judge Brown and every other judge that is out there on TV. (Just joking folks, disregard those last two sentences.) Since there was an absence of either statutory or contractual limitations, they used the common law applied by the state courts in similar cases. They placed that value as the "value of the film to the owner" or the INTRINSIC value. This is a critical point for it is this ruling that decided for the government the issue of "how much." In this case it was not only the cost of film; that new roll, per se, but it also included the cost of flying the film crew back over to Korea and reshooting the film. (ASBCA No. 29,831, Dynalectron Corporation, July 31, 1985).[3]

Let us go back to that item of ST. Now, in light of this decision, how much is the contractor liable? "Replacement or appreciated cost," one says. "But the government doesn't need it anymore; it was worthless junk," someone else says. I believe that this ruling is

a two edged sword. Consider that if the government, acting in good faith, claims that there is still a continuing need for that ST, then the contractor may be assessed for Replacement cost. If the government no longer has a need for that item of ST then it may very well be a Depreciated Cost. "But the government doesn't depreciate its property," you say.[4] How do I know what the depreciated cost is? More likely than not that cost will be nothing more than scrap value pennies on the pound for tool steel.

Below is a chart providing a visual reference as to the different degrees of valuation.

Why should the PA care how much the contractor is liable for? Let the ACO worry about that. I beg to differ. If we were to reference DFARS and its original documents giving us the historical perspective, we would find the Armed Services Procurement Regulation, alias the Defense Acquisition Regulation, Supplement 3, Part S3 602.2 (e)(ii). We find that one of the PA's responsibilities is not only to make those recommendations as to the contractor's liability but also as to the amount thereof. It is the PA's job and responsibility to make this recommendation. More on the PA's responsibilities later.

Let us move on to the next type of contract and liability concept.

Fixed Price Negotiated Contract

There are other types of fixed price contracts with Government Property Clauses where the clauses may not have the original language. Rather, they have the REGULAR Paragraph (h) of the clause. Remember that in the policy cited in 45.104, certain fixed price contracts generally do NOT hold the contractor liable. These are fixed price contracts of the negotiated variety. This is our second form of liability–liability under Fixed Price Negotiated Contracts or more frequently referred to as "Limited Risk of Loss." There are certain conditions that must be met for this type of contract to be used as well as for this risk of loss policy and provision to apply. Again, this is used when the contract price is not based upon (i) adequate price competition; (ii) established catalog or market prices of commercial items sold in substantial quantities to the general public; or (iii) prices set by law or regulation – or more significantly, the contractor is required to submit a certificate of current cost and pricing data (See FAR 15.403).

The Government Property Clause, FAR 52.245 1, used in this negotiated contract is the same as under our original fixed price sealed bid contract with one major exception. The Government Property Clause now uses REGULAR Paragraph (h) versus the Alternate I as required by 45.107(a)(2). This paragraph (h) is entitled "Contractor Liability for Government Property." Let us start with paragraph (h)(1). Here we see the statement that:

"Unless otherwise provided for in the contract, the Contractor shall NOT (Emphasis added) be liable for loss, damage, destruction, or theft to the Government property furnished or acquired under this contract, except when any one of the following applies…"

We have a reiteration of the theme set forth as policy in 45.104. Contractors are not liable for loss, damage, destruction or theft (L, D, D&T) unless it occurs under very specific circumstances. Here comes the tough part where we must carefully dissect the paragraphs describing under exactly what circumstances the government may hold the contractor liable.

Paragraph (h)(1(i)) " The risk is covered by insurance or the contractor is otherwise reimbursed (to the extent of such insurance or reimbursement)….

(ii) The loss, damage, destruction, or theft is the result of willful misconduct or lack of good faith on the part of the contractor's managerial personnel. Contractor's managerial personnel, in this clause, means the contractor's directors, officers, managers, superintendents, or equivalent representatives who have supervision or direction of all or substantially all of the contractor's business; all or substantially all of the contractor's operation at any one plant or separate location; or a separate and complete major industrial operation.

(iii) The Contracting Officer has, in writing, withdrawn the government's assumption of risk for loss, damage,

destruction, or theft, due to a determination under paragraph (g) of this clause that the contractor's property management practices are inadequate, and/or present an undue risk to the government, and the contractor failed to take timely corrective action. If the contractor can establish by clear and convincing evidence that the loss, damage, destruction, or theft of government property occurred while the contractor had adequate property management practices or the loss, damage, destruction, or theft of government property did not result from the contractor's failure to maintain adequate property management practices, the contractor shall not be held liable."

Let's analyze the three statements one at a time. Here we see the first circumstance or condition under which the government may hold the contractor liable. If conditions warrant, the government may require the contractor to carry insurance for a specific risk. But the contractor is only liable for that property covered by the insurance as well as only up to the amount of insured protection. In other words, if the insurance were for a face value policy of $10,000 and the lost property was for $12,000, the contractor's liability would be limited only to that $10,000 policy. There is an important item to note here. Contractors ordinarily CANNOT charge the government for insurance on government property —unless it is specifically directed to be acquired by the government. The last sentence of sub-paragraph (h)(1)(i) alludes to this prohibition.[5] It states:

"The allowability of insurance costs shall be determined in accordance with Part 31.205-19."

The government realizes that since this contract was or is not based upon adequate price competition, in this instance its burden of the risk, the insurance risk, for the protection of the government property is or would be inordinate and therefore there is a prohibition against the carrying of insurance. I'll talk about this concept under the heading of WHY?

Our second circumstance deals with incidents where, though no specific demand for insurance is made by the government, such as required earlier, there is in fact insurance coverage. The most obvious example of this requirement is your personal car insurance. A company employee is driving into the company parking lot and accidentally hits a piece of government property, damaging it. Is the contractor required to carry insurance to cover this damage? Generally, no! Then how can there be a "risk that is 'in fact' insured?" Simple—the government would request the contractor to go after the employee's automobile insurance coverage to pay for the property damage. Even though the government does not mandate that each and every employee carry automobile liability insurance, if such insurance does "in fact" exist—then the government wants to be made whole.[6] Paragraph (h)(3) clearly gives the government this right and option. It states, "The Contractor shall do nothing to prejudice the Government's rights to recover against third parties for any loss, damage, destruction, or theft of Government property."

These next two paragraphs are extremely important and extremely powerful.

Paragraph (h)(1)(ii) The loss, damage, destruction, or theft is the result of willful misconduct or lack of good faith on the part of the Contractor's managerial personnel. Contractor's managerial personnel, in this clause, means the Contractor's directors, officers, managers, superintendents, or equivalent representatives who have supervision or direction of all or substantially all of the Contractor's business; all or substantially all of the Contractor's operation at any one plant or separate location; or a separate and complete major industrial operation.

(iii) The Contracting Officer has, in writing, withdrawn the Government's assumption of risk for loss, damage, destruction, or theft, due to a determination under paragraph (g) of this clause that the Contractor's property management practices are inadequate, and/or present an undue risk to the Government, and the Contractor failed to take timely corrective action. If the Contractor can establish by clear and convincing evidence that the loss, damage, destruction, or theft of Government property occurred while the Contractor had adequate property management practices or the loss, damage, destruction, or theft of Government property did not result from the Contractor's failure to maintain adequate property management practices, the Contractor shall not be held liable.

These two items, (ii) and (iii), oft times provide people with the most problems either because of preconceived ideas or through the way that they operationalize various definitions. Let us look at some of these terms and their respective definitions. What do we mean by "willful misconduct." There is no definition of "willful misconduct" in the FAR. We have to look at the DoD Manual for the Performance of Contract Property Administration, 4161.2-M (Hereafter referred to as the DoD Property Manual). The DoD Property Manual provides a simple definition. It states in the definitions section and in Chapter 2:

"Willful misconduct. Either a deliberate act or failure to act that causes, or results in, the Loss, Damage, or Destruction to Government property."

I believe that all of us can comprehend or envision a deliberate or intentional act. Taking a baseball bat and in anger smashing a car window is most definitely a deliberate act. A failure to act might be characterized as borrowing your next-door neighbor's gas lawnmower; being warned that it needs oil and then operating it without ever checking the oil. Keep in mind that these are very simplistic examples. We could go to Black's Law Dictionary and find numerous examples but again, we'll leave the law for later.

"Lack of good faith. Failure to honestly carry out a duty including gross neglect or disregard of the terms of the Government property clause or of appropriate directions from the Property Administrator."

The DoD Property Manual and its definition of lack of good faith would appear to provide sufficient substance for us to determine what exactly would constitute an attribute under that definition. I won't address it further.

What I would like to do now is, in narrative form, present the infamous Drunken Fork Lift Operator Story. If you haven't seen it in person, I apologize—it loses something when presented in written form but I ask that you bear with me so I may make the necessary points to complete this analysis of liability.

At a large contractor's facility a forklift operator shows up for work one morning in a decidedly drunken state. The foreman of the forklift operators sees this employee and recognizes this state of drunkenness due to previous company sponsored alcohol and drug related awareness programs. Taking action, the foreman sends the employee to the locker room to change and go home. In the interim the Government's Property Administrator (PA) sees the foreman and they exchange pleasantries. The PA asks the foreman if the government owned equipment scheduled to be shipped today is at the loading bay dock. The foreman remembers that it is not but assures the PA that it will be there shortly. The PA leaves happy that he has done a good job. The foreman immediately rushes to the locker room, tells the forklift operator to return to work as the foreman needs a piece of equipment moved to the loading bay dock. "No problem" says the still drunk forklift operator as he quickly mounts his trusty forklift, loads that piece of equipment, proceeds to the loading bay dock at 50 miles per hour and upon reaching the loading bay dock launches the equipment into the air! Needless to say the equipment is destroyed. We will not talk about the drunken forklift operator–he escaped unscathed.

This is the question—Can the government hold the contractor liable for the loss, damage or destruction of that government property?

Before you hastily answer, think about it carefully. Remember my original words in this paper—DO NOT THINK EMOTIONALLY! Analyze this issue from an intellectual standpoint—not one of anger!

And on that note, I will leave you to consider the answer. Using the tried and true Steven Spielberg Indiana Jones "cliffhanger" approach you will just have to wait until the next issue of The Property Professional for the CONCLUSION of … LOSS, DAMAGE, DESTRUCTION, OR THEFT OF GOVERNMENT PROPERTY IN THE POSSESSION OF CONTRACTORS!!! ■

Part 2 of this article will appear in the July/August issue.

Endnotes

[1] It is important to note that we are addressing the record established by the contractor. Yes, the government in its financial accounting processes will depreciate the property. But that is different than the contractor applying and recording depreciation for government property in its records.

[2] I picked Wal-Mart because they are ubiquitous! No infringement of the trademark is intended nor is this an endorsement of their services or products.

[3] Small note—to add insult to injury Dynalectron was still required to process the replacement motion picture film under its contract with the United States government.

[4] This statement technically has changed because of changes in the Financial Management Regulations due to the Chief Financial Officer Act of 1990, which required the government to handle itself more like a commercial business, inclusive of maintaining of a general ledger. Though the government depreciates its assets, the government DOES NOT require contractors to depreciate government property in their possession.

[5] Note that FAR Part 31.205 also discusses the issue of charging the government for insurance as a Cost Principle.

[6] See FAR 52.245-1 (h)(3)